No. 86-44 (2)

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

SHEARSON/AMERICAN EXPRESS INC. and
MARY ANN McNULTY,

Petitioners,

v.

EUGENE McMAHON, JULIA McMAHON, individually and as trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON, INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; and THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

1. WHETHER THE CERTIORARI JURISDICTION OF THIS COURT MAY BE PROPERLY INVOKED TO RESOLVE AN APPARENT CONFLICT, THAT HAS ONLY RECENTLY ARISEN BETWEEN THE EIGHTH CIRCUIT AND THE SECOND CIRCUIT FOLLOWING OVER THIRTY YEARS OF THIS COURT'S SETTLED LAW, AS TO WHETHER A PURCHASER OF SECURITIES MAY BE COMPELLED TO RELINQUISH FEDERAL STATUTORY RIGHTS TO JUDICIAL REVIEW AND TRIAL OF CLAIMS ASSERTED UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. SECTION 78a *et seq.* (the "1934 Act"), THEREBY CONTRAVENING THE CLEAR INTENT OF CONGRESS; ESTABLISHED FEDERAL POLICY; THE UNBROKEN LINE OF PRECEDENTS OF THIS COURT; AND THE JURISDICTIONAL AND ANTIWAIVER PROVISIONS OF THE 1934 ACT?

2. WHETHER CLAIMS ASSERTED UNDER THE RACKETEER INFLUENCED CORRUPT ORGANIZATIONS ACT, 18 U.S.C. SECTION 1962(c) (1982) ("RICO") MAY BE ENFORCED IN OTHER THAN A JUDICIAL FORUM IN LIGHT OF THE CLEAR INTENT OF CONGRESS AND OVERRIDING PUBLIC POLICY CONCERNS?

3. WHETHER THE SECOND CIRCUIT COURT OF APPEALS SHOULD REMAND FOR FURTHER CONSIDERATION BY THE DISTRICT COURT THE ISSUE RAISED BELOW AS TO THE VALIDITY *AB INITIO* OF PURPORTED "AGREEMENTS" TO ARBITRATE CLAIMS ASSERTED UNDER THE 1934 ACT.

RULE 28.1 LIST OF PARTIES

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STATUTORY AND REGLATORY PROVISIONS INVOLVED

United States Arbitration Act

Sections 2-4, 9 U.S.C. Sections 2-4

Securities Act of 1933 (the "1933 Act")

Section 12(2), 15 U.S.C. Section 771(2)
Section 14, 15 U.S.C. Section 77n

Securities Exchange Act of 1934 (the "1934 Act")

Section 10(b), 15 U.S.C. Section 78j(b)
Section 19, 15 U.S.C. Section 78(s)
Section 27, 15 U.S.C. Section 78aa
Section 29(a), 15 U.S.C. Section 78cc(a)

Racketeer Influenced and Corrupt Organizations Act ("RICO")

Section 1962, 18 U.S.C. Section 1962
Section 1964(c), 18 U.S.C. Section 1964(c)

Securities and Exchange Commission Regulations

Rule 10b-5, 17 C.F.R. Section 240.10b-5
Rule 15c2-2, 17 C.F.R. Section 240.15c2-2

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* The text of these provisions is reproduced in full at Appendix A annexed to Petition, with the exception of 15 U.S.C. Section 78aa, discussed *infra*.

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v.

EUGENE McMAHON, JULIA McMAHON, individually and as trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON, INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; and THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

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RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

See Petition for Writ of Certiorari of Petitioners (hereinafter the "Petition") at 2, and A-6 to A-29 thereto.

JURISDICTION

See Petition at 2.

COUNTERSTATEMENT OF THE CASE

This is an action brought by Eugene McMahon and Julia McMahon individually and on behalf of various trusts (collectively "respondents") against Shearson/American Express, Inc. the predecessor of petitioner Shearson Lehman Brothers Inc. ("Shearson"), a brokerage firm registered with the Securities and Exchange Commission and against Mary Ann McNulty ("McNulty") (collectively "petitioners"), a registered representative, employee and vice president of Shearson, who was responsible for respondents' accounts during the time period referred to in the amended complaint. The amended complaint alleges in essence that petitioner McNulty, with the knowledge and consent of petitioner Shearson, engaged in the fraudulent and wilful churning, or practice of trading excessively solely to maximize commissions, not only of respondents' individual accounts, but also of the accounts for the trusts; intentionally and recklessly violated Section 10(b) of the Securities and Exchange Act of 1934, the 1934 Act, and Rule 10b-5 promulgated thereunder, by making false statements and omitting material facts in the advice given respondents and by fraudulently dissipating the funds of respondent Julia McMahon and those of numerous other investors representing the general public in a scheme known as the Golden Apple Hedge Fund; and violated the provisions of the RICO statute, 18 U.S.C. Section 1961, *et seq*. The amended complaint also alleges pendent common law claims of fraud, misrepresentation and breach of fiduciary duty.

Specifically, the amended complaint alleges as a first count multiple acts of fraudulent, inappropriate and excessive trading on the part of petitioners in connection with the joint account of the individual respondents, in which, for example, over 400 options were allegedly traded with commissions totalling approximately $50,000. As stated above, these options trades were not in accordance with respondents' stated conservative investment objectives and were not suited to secure their retirement objectives.

The second count of the amended complaint alleges claims of securities fraud by petitioners in relation to the four trust

accounts, where over 3,500 option trades are alleged in which petitioners reaped over $150,000 in commissions. Thus, on a quantitative level, the great majority of trading was performed in the trust accounts. Overall, over $200,000 in excessive commissions were allegedly earned by petitioners for these option trades.

The volatility of the options market was allegedly hidden from respondents, who were not given the information they requested regarding their accounts with petitioners nor were respondents in any way sophisticated in the securities field, having no college degrees nor financial industry acumen and no prior investment experience in anything more risky than municipal bonds, treasury bills and money market accounts.

The representations made by petitioners to respondents as asserted in the amended complaint, of a guarantee of appreciation through conservative investment policies, did not come to fruition. Indeed, it is alleged that the practices of petitioners caused the opposite result of steep losses.

The third count of the amended complaint alleges a scheme by petitioners to defraud respondent Julia McMahon and to utilize her good name in recruiting third parties to similarly invest in the Hedge Fund, where trading of options also occurred. The RICO count is pleaded on behalf of all respondents.

The course of the proceedings began when respondents filed their complaint on or about May 11, 1984. Petitioners vigorously contested this matter for almost one year before bringing on their motion to compel arbitration which was the subject of the appeal below. On July 13, 1984, petitioners filed a notice of motion to dismiss the complaint. Petitioners also filed their notice to take the depositions of the individual respondents. Following the filing of an amended complaint by stipulation, petitioners filed yet another motion to dismiss the amended complaint on January 14, 1985. During the pendency of petitioners' second motion to dismiss, petitioners moved to compel arbitration of respondents' claims on April 15, 1985,[1] almost one year after the

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[1] Not coincidentally, petitioners' motion to compel was filed shortly after this Court decided *Dean Witter Reynolds Inc. v. Byrd*, ____ U.S ____, 105 S. Ct. 1238 (March 4, 1985).

original complaint had been filed, and after petitioners had vigorously defended the lawsuit in the judicial forum during the lengthy period following the service of the original complaint.

The district court, per the Honorable Lloyd F. MacMahon, *declined* to dismiss any of respondents' claims, but nevertheless ordered arbitration of all respondents' claims except their RICO claims, temporarily stayed the RICO claims pending arbitration and placed the action on the district court's suspense docket pending the outcome of arbitration.

Respondents appealed to the United States Court of Appeals for the Second Circuit. Petitioners cross-appealed the district court's denial of their motion to arbitrate respondents' RICO claims.

On April 16, 1986, the Second Circuit affirmed in part and reversed and remanded in part, holding that the district court should not have departed from the Second Circuit's precedent in granting petitioners' motion to compel arbitration of 1934 Act claims. The Second Circuit affirmed the district court's denial of petitioners' motion to compel arbitration of the RICO claims and the lower court's direction as to arbitration of respondents' state law claims.

CERTIORARI SHOULD BE DENIED

The Second Circuit and every other Circuit Court but one that has decided the issue, either before or after this Court's decision in *Dean, Witter, Reynolds, Inc. v. Byrd, supra*, ____ U.S. ____, 105 S. Ct. 1238,[2] have adhered to the long-settled rule, established

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[2] Since *Byrd*, decisions have been rendered by the Fifth, Ninth and Eleventh Circuits in accord with the Second Circuit's decision in *McMahon*, barring arbitration of Section 10(b) claims. *See King v. Drexel Burnham Lambert, Inc.*, No. 85-1717 (5th Cir. May 28, 1986); *Miller v. Drexel Burnham Lambert, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) Par. 92,783 (11th Cir. June 17, 1986) (*per curiam*); *Conover v. Dean Witter Reynolds, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) Par. 92,831 (9th Cir. July 17, 1986), citing *McMahon v. Shearson/American Express*, 788 F.2d 94 (2d Cir. 1986). Petitioners have stated that currently *Miller* is under reconsideration *en banc* by the Eleventh Circuit (Petition at 15, n.7). Respondents currently are aware of arguments that have been held in cases that are *sub judice* in the Third and Fourth Circuits.

by Congress, federal policy and case law following this Court's decision in *Wilko v. Swan*, 346 U.S. 427 (1953), that pre-dispute arbitration agreements are unenforceable with respect to claims under Section 10(b) of the 1934 Act.

The lone, anomalous exception to this rule is the recent decision of the Eighth Circuit Court of Appeals in *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶92,815 (8th Cir. July 9, 1986), which, despite the precedents established by the other Circuits and this Court, enforced an agreement to arbitrate Section 10(b) claims.

The Court should deny certiorari because:

1. It would be improvident of the Court to exercise its discretionary review where only one of at least eight Circuit Courts of Appeals has diverged from the clear intent of Congress; established federal policy; the unbroken line of precedents of this Court; and the federal statutory rights afforded customers under the 1934 Act.

2. The Second Circuit's decision in this case correctly adhered to the well-settled exception to the Arbitration Act for claims under Section 10(b) of the 1934 Act, and the exception to the Arbitration Act for claims under RICO.

3. The decision below was so obviously correct as to warrant no further review.

I. This Court Should Deny Certiorari as an Improvident Exercise of Its Discretionary Review Where Only One of At Least Eight Circuit Courts of Appeals Has Diverged from the Clear Intent of Congress; Established Federal Policy; the Unbroken Line of Precedents In This Court; and the Federal Statutory Rights Afforded Customers Under the 1934 Act

A. Notwithstanding the Recent Apparent Conflict in the Circuits that Has Arisen Solely by Virtue of a Decision in the Eighth Circuit Court of Appeals, This Court Should Decline a Review of Its Own Settled Law

The thrust of petitioners' argument that review of this case is appropriate at this time is that the Eighth Circuit in *Phillips* disagreed with the Second Circuit's decision in this case, thereby creating a conflict within the Circuits.

However, the established rule in this Court is that a review on writ of certiorari rests firmly with the discretionary power of the Court, is not a matter of right and may, but need not, be granted when it arises by virtue of a decision by a federal Court of Appeals in conflict with the decision of another federal Court of Appeals on the same matter. *See* Supreme Court *Rule* 17(a); 13 Moore's Federal Practice, at SC 17-1 *et seq.*, Par. 817.01 *et seq.* (1985).

One need only look to the numerous Circuit Court decisions holding contrary to the Eighth Circuit's holding in *Phillips*, and conceded by the *Phillips* court in its opinion[3] (*Phillips, supra,*

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[3] *Contra Phillips*: *Miller v. Drexel Burnham, Inc., supra,* (11th Cir. June 17, 1986); *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94, 98 (2d Cir. 1986); *De Lancie v. Birr, Wilson & Co.*, 648 F.2d 1255, 1258-59 (9th Cir. 1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979); *Merrill*

(footnote continued)

[Current] Fed. Sec. L. Rep. (CCH) ¶92,815 at 93,989), to recognize that the *Phillips* decision is anomalous and neither represents the position of eight other Circuits on this issue nor the precedent of this Court. The apparent conflict created by *Phillips* is neither substantial nor important enough to warrant this Court's plenary review.

That *Phillips* is anomalous in the face of thirty-odd years of settled law following *Wilko* is illuminated by the dissent of the Honorable Circuit Judge Ross, a member of the Eighth Circuit panel, who objected strenuously from the *Phillips* decision, and stated the case herein succinctly:

> "I cannot agree with the majority's holding that predispute arbitration agreements are enforceable with regard to claims arising under section 10(b) of the 1934 Act and Rule 10b-5. I adhere to the position that *Wilko v. Swan*, 346 U.S. 427 (1953) applies and therefore precludes arbitration of such federal securities claims.
>
> I take this position for three reasons. First, *Wilko* is still good law, and as the majority points out, eight circuits have exended it to 1934 Act claims. *See ante* p. 6. Moreover, neither *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974) nor *Dean Witter Reynolds, Inc. v. Byrd*,

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Lynch, Pierce, Fenner & Smith, Inc. v. Moore, 590 F.2d 823, 827-29 (10th Cir. 1978); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 833-35 (7th Cir. 1977); *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 n.3 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 (3rd Cir.), *cert. denied*, 429 U.S. 1010 (1976).

The Fourth, First and D.C. Circuits do not appear to have ruled *per se* on this question to date. *See Land v. Dean Witter Reynolds, Inc.*, 617 F. Supp. 52 (E.D. Va. 1985); *Singer v. Dean Witter Reynolds, Inc.*, 614 F. Supp 1141 (D. Mass. 1985); *cf. Ingbar v. Drexel Burnham Lambert, Inc.*, 683 F.2d 603, n.1 (1st Cir. 1982) (recognized nonetheless that *Wilko* has been extended overwhelmingly by case law to 1934 Act claims).

Respondents respectfully submit that the proper course is to await the views of the Circuit Courts where decisions are pending before certiorari is granted on these issues.

> 105 S. Ct. 1238 (1985) hold that *Wilko* would not apply in the context of a section 10(b) or Rule 10b-5 claim. Second, in my judgment the similarity of the nonwaiver provisions of the 1933 Act and the 1934 Act is of critical importance because I view section 14 of the 1933 Act to be the lynchpin of the *Wilko* analysis. Third, the policy considerations which underlay *Wilko*, *see* 346 U.S. at 435-37, apply to the 1934 Act claims as well.
>
> Because of the absence of clear precedent in this circuit, I would give deference to the decisions of the Second Circuit in *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94, 98 (2d Cir. 1986) and the Eleventh Circuit in *Miller v. Drexel Burnham, Inc.*, No. 85-5692 (11th Cir. June 17, 1986) (per curiam)...and hold that claims under section 10(b) and Rule 10b-5 are not arbitrable. Accordingly, in the instant case I would affirm the order of the district court denying the motion to compel arbitration of the claims arising under the 1934 Act."

Phillips, *supra*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,815 at 93,992 (citation omitted).

The Second Circuit's opinion below, and *not Phillips*, is clearly consistent with the long line of precedents in this Court beginning with *Wilko v. Swan*, *supra*, and followed by *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974); *Herman and MacLean v. Huddleston*, 459 U.S. 375 (1983); *Dean Witter Reynolds, Inc. v. Byrd*, *supra*; *Bateman Eichler v. Berner*, ____ U.S. ____, 105 S. Ct. 2622 (1985); and *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, ____ U.S. ____, 105 S. Ct. 3346 (1985).

It is significant, therefore, that the Petition (at 7-9) relegates the numerous progeny in the Circuits of this Court's holding in *Wilko v. Swan* to mere footnote status. The Petition belabors the erroneous and misleading presumption that the *McMahon* decision somehow reflects a judicial distrust of arbitration by the Second Circuit. Nothing could be farther from the truth, since the Second Circuit has stated on many occasions that its decisions

and policy "reflect exactly the contrary point of view." *American Safety Equipment Corp. v. J.P. Maguire & Co.*, 391 F.2d 821, 827 (2d Cir. 1968), citing *South East Atl. Shipping Ltd. v. Garnac Grain Co.*, 356 F.2d 189, 192-193 (2d Cir. 1966); *Kulukundis Shipping Co., S/A v. Amtorg Trading Corp.*, 126 F.2d 978, 985 (2d Cir. 1942).

Needless to say, the Petition fails utterly to disclose the public policy rationale underlying the Second Circuit's decision in this case, as will be discussed below, and the remedial purpose intended by Congress in enacting the securities laws and in amending them in 1975. Instead, petitioners attempt to draw the Court's attention away from the policy rationale extending *Wilko* to the 1934 Act by drawing artificial distinctions between the 1933 Act and the 1934 Act, thereby attempting to limit the applicability of *Wilko* to Section 10(b) claims.

As this Court recognized in *Herman and MacLean v. Huddleston*, *supra*, 459 U.S. at 384-389, the rights afforded under the 1933 and 1934 Acts are cumulative and are in support of their remedial purpose, and "[t]he effectiveness of the broad proscription against fraud in Section 10(b) would be undermined if its scope were restricted by the existence of an express remedy under Section 11. *Id.*, 459 U.S. at 386 (citations omitted). Under this Court's holding in *Herman & MacLean v. Huddleston*, any interpretation of the securities laws that would have the effect of displacing an action under Section 10(b) was *explicitly rejected*. *Id.*, 459 U.S. at 387. Thus, it is respectfully submitted that this Court should discourage clearly any attempt to undermine the so-called "implied" but judicially and congressionally recognized right of action under the 1934 Act simply because there exists an "express" remedy under the 1933 Act.

The policy considerations which gave vitality to *Wilko* and the case law that followed its teachings is documented in the cogent dissent in *Scherk v. Albert-Culver Co.*, *supra*, which was joined by Justice White:*

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* Whether or not intended, *dicta* in Justice White's subsequent concurring opinion in *Byrd* has somehow formed the basis for some judicial interpretation

(footnote continued)

> "We spoke at length in *Wilko* of this problem, elucidating the underdesirable effects of remitting a securities plaintiff to an arbitral, rather than a judicial, forum. Here, as in Wilko, the allegations of fraudulent misrepresentation will involve 'subjective findings on the purpose and knowledge' of the defendants, questions ill-determined by arbitrators without judicial instruction on the law. See [*Wilko*, 346 U.S.] at 435. An arbitral award can be made without explication of reasons and without development of a record, so that the arbitrator's conception of our statutory requirements may be absolutely incorrect but functionally unreviewable, even when the arbitrator seeks to apply our law. We recognized in *Wilko* that there is no judicial review corresponding to review of court decisions. *Id.* at 436-437. The extensive pretrial discovery provided by the Federal Rules of Civil Procedure for actions in district court would not be available. And the wide choice of venue provided by the 1934 Act, ..., would be forfeited. See *Wilko v. Swan*, *supra*, at 431, 435. *The loss of the proper judicial forum carries with it the loss of substantial rights.*"

Scherk v. Alberto-Culver Co., *supra*, 417 U.S. at 532 (citation omitted, emphasis added).

Neither *Scherk* nor *Mitsubishi*, *supra*, which were decided in the context of international disputes, nor the *Byrd* decisions of this Court altered the applicability of *Wilko* in the context of Section 10(b) or Rule 10(b)-5 claims. Indeed, the rationale of *Wilko v. Swan* was approvingly recognized by this Court in *Byrd* to have "retained considerable vitality in the lower federal courts" with respect to claims arising under Section 10(b) of the 1934 Act; the Court acknowledged that "agreements to arbitrate [1934 Act] claims are therefore unenforceable." *Byrd*, *supra*, at 1240,

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contra the extension of the *Wilko* doctrine to 1934 Act claims. Many courts, however, have continued to adhere to the *Wilko* rule. *See* Petition at Appendix E, subparagraph B, at A-38 to A-42.

n.1. Also in *Byrd*, this Court, albeit in another context, conceded that "arbitration cannot provide an adequate substitute for a judicial proceeding" in protecting certain federal statutory rights that are statutorily safeguarded. *Id.*, at 1243.

Thus, the citation in the Petition (at 9, n.5) of the rules that obtain in the various stock exchange arbitration proceedings and generally under the N.A.S.D. Uniform Code of Arbitration is misplaced. There is simply no evidence to demonstrate that the defrauded investor would be in any way adequately protected as to his or her substantive rights under the securities laws without the protection and safeguards available only in litigation, as outlined in *Wilko*. Since the "substantial rights" inherent in litigation are generally unavailable in arbitrations of securities law claims, federal court litigation of Section 10(b) claims and arbitration of pendent state law claims, the "bifurcated" proceedings mandated by *Byrd*, cannot fairly be construed as duplicative either substantively or procedurally. (*contra* Petition at 17, n.12).

The Court should, therefore, deny the Petition and decline to review the settled law on this issue, thereby affirming the Second Circuit's application of *Wilko* barring arbitration of respondents' 1934 Act claims.

B. The Second Circuit's Decision in This Case Correctly Adhered to the Well-Established Exception to the Arbitration Act for Claims under Section 10(b) of the 1934 Act

1. This Court's Recent Decisions and Second Circuit Precedent Support the Applicability to This Case of *Wilko v. Swan* Precluding Arbitration of Respondents' 1934 Act Claims

As stated above, the Eighth Circuit's decision in the *Phillips* case is anomalous for its failure to defer to the overriding precedents in the other Circuits precluding arbitration of federal securities claims under Section 10(b). The Second Circuit, by relying on its own precedent, correctly followed the exception to the Arbitration Act carved out by *Wilko*:

> "As our late colleague, Judge Friendly, noted in *Colonial Realty v. Bache & Co.*, 358 F.2d 178, 183 n.5 (2

> Cir.), *cert. denied*, 385 U.S. 817 (1966), the non-waiver provision of Section 14 of the 1933 Act has an almost identical counterpart in Section 29(a) of the 1934 Act. In view of *Wilko* and the similarity of the non-waiver provisions of the 1933 and 1934 Acts, we consistently have held that Section 10(b) and Rule 10b-5 claims are not arbitrable. In *Greater Continental Corp. v. Schechter*, 422 F.2d 1100, 1103 (2 Cir. 1970), we observed that alleged violations of Rule 10b-5 were 'properly litigated in the courts where a complete record is kept of the proceedings and findings and conclusions are made.' We also pointed out the similarity between Section 14 of the 1933 Act and Section 29(a) of the 1934 Act. *Id.* In *Allegaert v. Perot*, 548 F.2d 432, 436-38 (2 Cir.), *cert. denied*, 432 U.S. 910 (1977), we reiterated the view that claims under Section 10(b) of the 1934 Act are not arbitrable, noting that the broad policy questions involved in securities law claims require a judicial forum for resolution of disputes. Again in *AFP Imaging Corp. v. Ross*, 780 F.2d 202, 205 (2 Cir. 1985), [*cert. denied*, June 30, 1986] we held that, in an action which alleged violations of Section 10(b) and Rule 10b-5, an arbitration clause in the contract was 'unenforceable under the law of this Circuit.' "

McMahon, *supra*, 788 F.2d at 96-97.

The Second Circuit in the *McMahon* decision correctly followed the holdings of this Court by recognizing that the distinctions between the 1934 Act and the 1933 Act are, in practical terms, distinctions without real differences. Thus, this Court has determined and recognized that the provisions of the Act are not coextensive with common law doctrines of fraud, *Herman & MacLean v. Huddleston*, *supra*, 459 U.S. at 388-89, and that "a private right of action under Section 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. *The existence of this implied remedy is simply beyond peradventure.*" *Id.*, at 380 (citations omitted, emphasis added) citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *See also Bateman Eichler v. Berner*, *supra*, ____ U.S. ____, 105 S. Ct. at

2628 (the court rejected the argument that an implied remedy under Section 10(b) stood on any different footing from an express federal statutory remedy, citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)). The Second Circuit also recognized, just as Justice White did in *Byrd*, that the non-waiver provision of Section 14 of the 1933 Act and its counterpart in Section 29(a) of the 1934 Act are almost identical.

Nothing in any of the recent holdings of this Court can be fairly interpreted as in conflict with the well-reasoned decision of the Second Circuit in *McMahon*. Indeed, in *Mitsubishi*, *supra*, this Court, noting the international nature of the contract and dispute there, nonetheless acknowledged an exception to arbitration in regard to claims in a domestic dispute. 105 S. Ct. at 3355, citing *American Safety Equipment Corp. v. J.P. Maguire & Co.*, *supra*, 391 F.2d 821.

2. The Second Circuit's Decision Correctly Analyzed Congressional Intent in Furthering the Remedial Purpose of the 1934 Act

A fortiori, it is clearly evident from the legislative history of the securities laws and their scope that Congress intended to create the right of action to enforce the duties arising under Section 10(b) of the 1934 Act. The right to a judicial forum is a right that cannot be waived under Section 29(a) of the 1934 Act, since Section 27 of the 1934 Act expressly grants jurisdiction to federal district courts over violations of the Act and suits to enforce any liability or duty thereunder and provides for venue and service of process. It creates no cause of action of its own force and effect and imposes no liabilities.[5] *Touche Ross v. Reddington*, 442

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[5] Section 27, as set forth in 15 U.S.C. Section 78aa, provides, in pertinent part, as follows: "The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States *shall* have exclusive jurisdiction of violations of this chapter or the *rules* and *regulations* thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the *rules* and *regulations* thereunder." (emphasis added). Respondents submit that Congress thus *intended* that the *right* to a judicial *federal* court forum given under Section 27 is unwaivable and may not be forfeited by virtue of Section 29(a) of the 1934 Act.

U.S. 560, 99 S. Ct. 2479, 2481 (1979). Finally, the right of action under Section 10(b) carries with it the requirement that the plaintiff must prove that the defendant acted with "scienter," thus imposing a heavier burden of proof that is least likely to be accomplished in an arbitration proceeding, where discovery is essentially voluntary and not subject to the protections of the Federal Rules of Civil Procedure.

The remedial purpose of the 1934 act is well-documented. Just last term, Justice O'Connor, who delivered the opinion of the Court in *Randall v. Loftsgaarden*, held that:

> "Congress' aim in enacting the 1934 Act was not confined solely to compensating defrauded investors. Congress intended to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions. *Affiliated Ute Citizens, supra*, at 151; see also *Hermann & McLean*, 459 U.S., at 386-387."

Randall v. Loftsgaarden, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,801 at 93,920 (July 2, 1986).

No amount of equivocation by petitioners, urging the subjugation of the 1934 Act to the broker-dealers' well-known predilection for a non-judicial forum to air claims against them, alters this legislative history. As the Ninth Circuit held just recently in *Conover v. Dean Witter Reynolds, Inc.*, *supra*, the unbroken line of precedent in this Court and the Circuits upholding the *judicial* forum for 1934 Act claims was left undisturbed by Congress in its 1975 examination of the securities laws:

> "The legislative and judicial history tells us, [first, that the implied cause of action in federal court...has become well-established, and its nonwaivable character has become well accepted by the SEC, the courts and Congress] second, that Congress could have eliminated the federal cause of action for section 10(b) in 1975, when it undertook comprehensive revision of the 1933 and 1934 Act, had it chosen to do so. Congress' revision, however, left section 10(b) intact.

> "The history tells us, third, and most important, that in 1975, Congress expressly recognized the non-arbitrable nature of disputes between brokers and customers. In the conference report to the Securities Act Amendment of 1975, Congress emphasized that its amendment to section 28 of the Securities Exchange Act of 1934, which permitted arbitration agreements between brokers and exchanges, did not extend to arbitration agreements between brokers and customers:
>
> > 'It was the clear understanding of the conferees that this amendment did not change existing law, as articulated in *Wilko v. Swan*, 346 U.S. 427 (1953), concerning the effect of arbitration proceeding provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.'
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> H.R. Rep. No. 229, 94th Cong., 1st Sess. 111, *reprinted in* 1975 U.S. Code Cong. & Ad. News 321, 342."

Conover v. Dean Witter Reynolds, Inc., *supra*, [Current] Fed. Sec. L. Rep., par. 92,831 at 94,042. *See also Hermann & McLean v. Huddleston*, *supra*; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 379 (1982) (finding comprehensive amendments to Commodities Act evidence that Congress intended preservation of implied remedy under the Act).

Clearly then, when all factors are considered — the purpose, the legislative history and the focus and language of the statute itself — the exception to the Arbitration Act for claims under Section 10(b) of the 1934 Act must be upheld. This result is mandated by over 30 years of this Court's settled law, the clear intent of Congress, established federal policy and the federal statutory rights afforded customers under the 1934 Act. For all the above reasons, the decision of the Second Circuit in *McMahon* should be affirmed, and the Petition should be denied.

II. The Second Circuit Correctly Held That RICO Claims May Not Be Compelled To Be Arbitrated Because of Congressional Intent, the Views of This Court and Public Policy Considerations

A. Congress Intended to Create an Exception to the Arbitration Act for Civil RICO Claims

The grant by Congress of federal court jurisdiction of RICO claims is expressly provided in 18 U.S.C. Section 1964(c):

> "Any person injured in his business or property by reason of a violation of Section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the costs of the suit, including a reasonable attorney's fee."

Thus Congress incorporated into the RICO statute the almost identical jurisdictional provision of the analogous federal antitrust laws, embodied in 15 U.S.C. Section 15. The antitrust analogy has and continues to form the basis for encouraging private enforcement of RICO claims. *See* Petition, citations at 21, n.17; *Sedima, S.P.R.L. v. Imrex Co.*, ____ U.S. ____, 105 S. Ct. 3275, 3282 (1985).

Following the enactment of the RICO statute, numerous district courts within nine Circuits[6] have held the arbitration of RICO claims to be unsuitable and indeed entirely improper because of public policy concerns that cannot be adequately protected by the arbitration procedure. Thus, the majority of courts have recognized fully that the rationale behind Congress' intent in precluding the arbitration of RICO claims has its genesis in the policy reasons underlying prohibition of arbitration of domestic antitrust claims. *See S.A. Mineracao da Trinidad-Samitri v. Utah International Inc.*, 576 F. Supp. 566 (S.D.N.Y.

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[6] *See* Petition at Appendix "F", subparagraph B, A-46 to A-48, conceding the federal judiciary's widespread adherence to the nonarbitrability of RICO claims.

1983), *ordered certified for interlocutory appeal*, 579 F. Supp. 1049 (S.D.N.Y.), *appealed on other grounds and affirmed*, 745 F.2d 190 (2d Cir. 1984). *Accord, American Concept v. Irsay*, No. 84 C 10026 (N.D. Ill. October 4, 1985); *Sevignor v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 84-3240-N (D. Mass. July 19, 1985); *Witt v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 602 F. Supp. 867, 870 (W.D. Pa. 1985); *Universal Marine Insurance Co., Ltd. v. Beacon Insurance Co.*, 588 F. Supp. 735, 738 (W.D.N.C. 1984); *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 605 F. Supp. 510 (W.D. Pa. 1984).

B. Public Policy Concerns Inherent in RICO Actions Preclude Arbitration

Contrary to the transparent *ipse dixit* argument of petitioners that because RICO claims involve commercial disputes somehow they do not implicate public policy,[7] the opposite postulate adheres. As the Second Circuit observed in *McMahon*, in correctly comparing the policy concerns shared in enforcement of both the RICO statute and the antitrust laws:

> "In *American Safety Equipment v. J.P. Maguire*, 391 F.2d 821 (2d Cir. 1968), we stated that '[a] claim under the antitrust laws is not merely a private matter. The Sherman Act is designed to promote the national interest in a competitive economy; thus, the plaintiff asserting his rights under the Act has been likened to a private attorney-general who protects the public's interest.' 391 F.2d at 826. We hold that there are comparable concerns inherent in the enforcement of RICO claims."

McMahon, supra, 788 F.2d at 98.

Moreover, this Court's decision in the *Mitsubishi* case, which arose in the context of an international dispute, was not meant to nor does it emasculate the reasoning of the Second Circuit as applied to agreements to arbitrate in the context of domestic transactions:

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[7] Petition at 25.

> "Enforcement of the RICO statute is particularly appropriate in a judicial forum because of strong policy concerns, the need for development of the record, and judicial clarification and resulting consistency in resolving disputes under this relatively new statute."

McMahon, *supra*, 788 F.2d at 98-99.

Despite petitioners' offhanded characterization of the "typical" RICO claim (*see* Petition at 25-27), the proper development of the law underlying the RICO statute is best left to the courts at this time. Because of the newness of decisions under the RICO statute, and in the absence of congressional clarification or action currently to amend the statute, it is imperative that the courts develop the law under RICO so as to provide the following safeguards, *inter alia*: judicial fact-finding; the rules of procedure and evidence that do not apply in the typical arbitration proceeding; the benefit of a complete record; additional safeguards of appellate review of RICO decisions; judicial expertise in interpreting this relatively new statute; and the deterrent effect of enforcing RICO in the federal courts to protect the public interest. *See generally McDonald v. City of West Branch, Michigan*, U.S., 104 S. Ct. 1799 (1984). Arbitration is simply not an adequate forum for civil enforcement of important federal statutory law and policy. *See*, *e.g.*, *Barrentine v. Arkansas-Best Freight System, Inc.*, 450 U.S. 728 (1981) (employee's claims under Fair Labor Standards Act nonarbitrable); *McDonald v. City of West Branch*, *supra*, (claims under the Klu Klux Klan Civil Rights Act of 1871 nonarbitrable); *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974) (claims under Title VII of Civil Rights Act of 1964 nonarbitrable).

It is no wonder then, in light of the weighty policy concerns supporting litigation of RICO claims, that petitioners mention the holding of this Court in *Sedima*, *supra*, almost as an afterthought.[8] In *Sedima*, this Court recommended that in order to effectuate its remedial purpose, the RICO statute "is to be read broadly." *Sedima*, *supra*, 105 S. Ct. at 3286. Petitioners, however,

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[8] *See* Petition at 18, 22.

argue that an arbitration agreement would probably never arise in a "legitimate" RICO claim. *See* Petition at 27. *Sedima*, however, sets to rest petitioners' thinly veiled implication that organized crime involvement is a necessary element of a claim brought under the RICO statute. And the fact that the RICO claims in this case are predicated upon 1934 Act securities law violations is but a final reason for affirming the Second Circuit's decision that courts and not arbitrators must hear both 1934 Act claims and RICO claims at the same instance.

Because the Congress explicitly intended that RICO claims should have a federal judicial forum and should not be arbitrated, and because of the underlying, significant public policy considerations supporting the litigation of civil RICO claims, the Second Circuit's decision in this regard should be affirmed without hesitation by the Court, and the Petition should be denied.

III. Respondents' Claims Are Not Subject to Arbitration Since the Arbitration Provision of Their Purported "Agreement" Is Inapplicable and the Parties Did Not Intend the Petitioners' Misconduct to be Subject to Any Arbitration Provision, Which in This Case Was Allegedly Procured By Fraud

As was briefed in the appeal before the Second Circuit below, the form of purported customer "agreement" allegedly signed by the individual respondents in connection with their accounts and the accounts of the various trusts were not only prepared by petitioners' alone but were not subject to any negotiation whatsoever between the parties. It is important to keep in mind that the so-called customer agreement containing these standard arbitration clauses is not an agreement as between industry professionals but between brokerage professionals and the ordinary customer with typically no bargaining power as to the contents of the form agreement.

This Court recognized in *Mitsubishi* that "the first task of a court asked to compel arbitration of a dispute is to determine whether the parties agreed to arbitrate that dispute." *Mitsubishi*, *supra*, 105 S. Ct. at 3354. This Court went on to instruct that "[o]f course, courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for the revocation of any contract.' " *Id.*, *citing* 9 U.S.C. Section 2; *Southland Corp. v. Keating*, 465 U.S. 1, at ____ n.11, 104 S. Ct., at 861, n.11 (1984); *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15, (1972). Here, as likely happens in the typical relationship between broker-dealers and customers, respondents signed these boilerplate forms as a necessary requirement of beginning the relationship, a mere formality in which the customer is not asked to nor expected to read the small, fine print of the form.

At the time that the purported "agreements," in the form of the standard customer agreement, containing the so-called "arbitration" clause, were entered into by the parties hereto, it is

indisputable that the Circuit Courts of Appeals had uniformly adhered to the position that *Wilko v. Swan* precluded the arbitration of all securities claims, whether arising under the 1933 Act or the 1934 Act. (*See* case law cited hereinabove). As was noted *infra* in respondents' counterstatement of the case, it was not until the concurrence of Justice White appeared in the *Byrd* case that petitioners moved to compel these claims to arbitration in the district court. In fact, petitioners could not rely upon the majority opinion of the Court in the *Byrd* case, since the brokerage firm there did not seek to compel arbitration of federal securities claims but only of pendent state law claims. Thus, respondents should not be held to be bound by a purported "agreement" to arbitrate that was unenforceable at the time it was allegedly entered into by the parties.

Moreover, the purported agreements to arbitrate herein were fraudulently obtained, on two separate grounds. First, the inclusion of the arbitration clause in an agreement such as that at issue in *McMahon* (mandating arbitration in any controversy arising out of disputes between customers and broker-dealers) was as early as 1979 characterized by the SEC as a "fraudulent practice." *See* SEC Act Release No. 15984 (July 2, 1979), 17 SEC Docket 1167 (1979), [1979] Fed. Sec. L. Rep. (CCH) Par. 82,122. (SEC Release, warning broker-dealers that they should make customers aware of rights to a judicial forum to pursue 1933 and 1934 Act claims, notwithstanding arbitration agreements). The SEC since that time has reaffirmed its dim view of mandatory arbitration agreement language by enacting SEC regulation 15c2-2, 17 C.F.R. Section 240.15c2-2. The SEC, in Exchange Act Release No. 20397, clearly determined mandatory arbitration clauses to be "a misleading statement of customers' rights under the federal securities laws." (November 28, 1983) reprinted in [1983-84 transfer binder] Fed. Sec. L. Rep. (CCH) Par. 83,452 at 86,357.[9] Although the latter SEC regulation and release may

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[9] *See, Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 81 L. Ed.2d 694, 703 (1984) ("[Agency] regulations are given controlling weight unless they are arbitrary, capricious or manifestly contrary to the statute.").

have been enacted following the execution of the agreements at issue here, nevertheless, it is important to note that the cumulative effect of the SEC's position apparently is to affirm the extension of *Wilko v. Swan* to claims arising under the 1934 Act making agreements to arbitrate such claims unenforceable.[10]

It is well-settled that the question of whether the arbitration provision at issue here was obtained by fraud is one for a court and not an arbitration panel to deliberate upon and decide. *See Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 403-04 (1967). Further, "a court may not order arbitration until it is satisfied that a valid arbitration agreement exists. *See* 9 U.S.C. Section 4." *Miller v. Drexel Burnham Lambert, Inc.*, *supra*, [Current] Fed. Sec. L. Rep. (CCH), Par. 92,783 at 93,858.

The evidence that the purported agreements herein were induced by fraud was not before the district court below, a point that was briefed before the Second Circuit. It is respectfully requested that, in the event this Court renders a summary affirmance herein, the Court should additionally remand for the district court's consideration the question of the fraudulent inducement of the agreements at issue.

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[10] Indeed, petitioners unhesitatingly point to the SEC's manifest "jurisdiction to correct any perceived abuses or unfairness" substantively, vis a vis arbitration rules, citing Section 19 of the 1934 Act, 15 U.S.C. Section 78s. (Petition at 9, n.5).

CONCLUSION

This Court should deny the Petition for a Writ of Certiorari. There is no substantial split in the Circuits on the issues presented herein, and, in fact, almost without exception the Circuits are in agreement in extending the *Wilko* doctrine to 1934 Act claims. To accept *certiorari* at this time would constitute a waste of the precious resources of this Court on a settled issue which only recently has been called into question by one Circuit Court decision. Further, a change at this time in the well-settled law affording purchasers of securities a judicial forum for their federal statutory rights would contravene the clear intent of Congress, established federal policy, the unbroken line of precedents of this Court, and the jurisdictional and non-waiver provisions of the 1934 Act, Section 27 and 29(a), respectively. Moreover, the intent of Congress and overriding public policy concerns mandate that respondents' RICO claims be enforced in the federal judicial forum. Finally, the question as to the validity *ab initio* of the purported "agreements" should be remanded for further consideration by the district court in light of respondents' claim of fraud in the inducement thereof. The decision of the United States Court of Appeals for the Second Circuit should be affirmed herewith. The Petition for a Writ of Certiorari should be denied.

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